

# Public vs. Private Credit: Competitors or Allies?

Disruptive Forces in Investing

May 18, 2021

- Anu Rajakumar:** The growing size, depth and breadth of private markets has opened up quite a few options for investors. And in particular private credit continues to play a significant role in financing corporate growth. As we begin to view public and private markets exposure more holistically, particularly after the tumultuousness that COVID-19 brought on markets, we've brought back the experts to share more about the dynamics at play within the fixed income market, and how they work together, or not, in regards to portfolio development. My name is Anu Rajakumar, and I'm delighted to have back both Susan Kasser, Head of Private Debt, and Ashok Bhatia, Deputy CIO of Fixed Income. Susan and Ashok, thank you very much for joining me today.
- Susan Kasser:** Great to be back, Anu. Thanks for having us.
- Ashok Bhatia:** Yeah, thanks for inviting us.
- Anu:** So we've had you both on the show before to share both of your perspectives on both public and private credit but would love to give our listeners a quick refresher on some of the basics. So, Susan, maybe starting with you, just quickly share what sort of private debt you focus on, and then also just touch on some of the evolutions within the space in the last decade or so since the GFC.
- Susan:** Well, we lend to private companies in the United States that are owned by private equity funds. Uh, these companies are larger than one might expect. Think 500 million to a billion dollars of revenue, and on average 50 million of EBITDA or cash flow. Private debt has actually been around almost as long as the high yield market. It originated as a substitute for the high yield market. Uh, but the asset class has grown significantly following the global financial crisis. And this is for a number of reasons. Institutional investors were searching for yield in a low rate environment. Kind of like today. Regulatory changes favored asset managers over commercial and investment banks in terms of who should hold these loans. And last but not least, growing interest in private equity, and therefore more private equity capital, increased demand for all sorts of financing, including but not limited to private debt. By now it's fair to say it's pretty standard to have private debt in your portfolio, whether you're a pension fund, insurance companies, foundations or even individual investors.
- Anu:** Perfect, thank you very much. And turning to you, Ashok, public fixed income is of course an older and larger, and possibly a more familiar market than private debt. If you could just share briefly, you know, broad evolution of the markets in the last decade or so. And also, I'd like for you to touch on impact of overall monetary policy and interest rates, given how dramatically public debt has increased, particularly as a result of COVID-19.
- Ashok:** Sure. And maybe I can start by just picking up on something, you know, Susan hit on, which is the question of the structural changes in the public markets or the bond markets, over the last ten years. I mean, I think one of the really important ones has been some of the regulatory changes that we saw after the financial crisis, and Susan made the point that the private debt markets have been around for a long period of time. But these regulatory changes have certainly helped the growth of the private debt markets. Whether it's lending to certain size companies in the corporate space, consumer finance, residential mortgages in the US. There're pockets of fixed income that used to be done by the public markets that because of regulatory changes they've really been shifted into the private markets. And so, you know, over the last ten years that been a pretty important trend of growth of-of private fixed income. Certainly helped along by these likely quasi- or permanent regulatory changes. And then, you know, I think the second question, Anu, that you raised, which is the impact of monetary policy and debt, and some of these issues. And I think there's been two developments that are really the most important. The first is, you know, coming out of COVID, there's been a dramatic expansion of public sector debt. Government debt, lending or borrowing to support the recovery, federal deficits, etcetera. And it's not just the US, it's going on in Japan, it's going on in Europe, it's going on in China. Now, a lot of this public-public sector debt is being bought by the central banks, so in some ways it's-it's not quite as visible to us. Uh, but it's there. And then, you know, the second development has been, um, corporations, and corporations increasing in issuing, um, more debt.

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In this case a lot of it's just being held as cash. Um, companies are, like a lot of us, you know, there's a lot of uncertainty about how the global economy is going to reopen. So there's also been an increase in corporate debt, um, but it's generally being held as cash for precautionary reasons by a lot of companies.

**Anu:** Great, thank you so much for sharing that. Um, you know, I think the – the crisis last year was an important reminder that investors have a need for stable income, and there was certainly a focus on, you know, yield without duration or interest rate risk. Um, I was wondering if you could each talk a little bit about what people were worried about in terms of credit both pre-COVID, and what are they worried about now. Maybe starting with you, Susan.

**Susan:** Yeah, I think investors had begun to have an ill-defined unease about private debt, really as a victim of its own success. Um, any metric you would look at the asset class had grown tremendously over the last ten years. Assets under management, number of managers, mentions in the media, dedicated conferences, solicitation in people's inboxes, etcetera.

Um, and so I think investors, uh, sort of fairly wondered, given how long, um, it had been since the last recession, whether the private debt asset class was really as defensive as people thought it was. And that really has been a silver lining of COVID. Uh, the pandemic has provided a really dramatic test to companies', near-term revenues and earnings, and therefore, of course, lending to them, individually or in a portfolio. And I think the asset class has come out very strongly, and it's reminded people about its defensive attributes.

So first and foremost, as you mentioned, Anu, um, in private debt, investor returns are generated by contractual cash coupons. Uh, these are paid by the individual borrowers, you know, to the asset manager, and are distributed from the asset manager to the individual investors. Um, this was not really affected, uh, by the events in 2020. And I think people really valued those distributions. If you think about other asset classes, liquid asset classes, a big part of returns are price appreciation. That was certainly a wild ride in 2020. Or in private equity returns are really driven by a sale of underlying assets, and therefore distributions. And there wasn't as much of that in 2020 as there normally would be. Second positive attribute would simply be minimal price volatility. That's a beauty of an illiquid asset class. Of course valuations move around, but they move around only because of fundamental changes in valuation, and not because of market sentiment, right, which can see-saw far more wildly. And then at the end of the day, private debt is mostly loans to companies, senior debt, top of the capital stack. Defaults are low, recoveries are high. Um, and the market is generally lending at 40 to 50 percent loan-to-value. Uh, that means the value of a company has to fall by more than half in order for a senior loan to be impaired. Last but not least, most of private debt is lending to companies that are owned by private equity funds. Private equity funds control the governance at companies, and they have the ability to invest more capital into the companies that they own, very quickly. And we certainly saw that as a benefit in 2020. Private equity firms moved very quickly to safeguard, uh, physically their employees and their customers, then to preserve liquidity. And finally, when needed, to invest more equity capital into their businesses to support them. And this, of course, always benefits the creditors to those businesses as well.

**Ashok:** And I think the public markets, there's certainly some similarities, or a lot of similarities, on the pre-COVID and post-COVID environment. I mean, pre-COVID or in the COVID environment it was really about growth, and, are we going to see a wave of corporate and individual defaults and delinquencies that bond owners are not going to get their money back because we're going to go into a global recession. And I think fortunately we saw a lot of fiscal stimulus and a lot of monetary stimulus that pretty quickly put that risk to bed. But it has partly opened up the new risk that the public markets are focused on, and that's related to inflation risk. You know, it's not hard to see. You know, we see stories about ships shortages, lumber prices, gasoline prices. Price pressures are building, you know, across the board. And that's resulting in a transition I think, of what the public markets are most concerned about. It's away from recession risk and more to inflation risk. And that inflation risk is going to likely result in investors looking for different portfolio solutions. It's about, you know, how do you earn income without taking a lot of duration risk? It's what are the sectors that benefit from rising prices, and what sectors are going to be the most impacted by it? So, the COVID environment and the response to it is leading to, you know, I think the beginning of a shift in public market focus. But again, you know, like Susan said, the private markets lend to companies, and ultimately want to get their money back, and that's a big, big similarity with the public fixed income markets.

**Anu:** Yeah, thank you. And Ashok, something that you said I think is a great segue into my next question. You know, you talked about as we're in this new economic cycle, investors are looking at different solutions: whether that's just in their asset allocation in preparation for a different regime in inflation, or elsewhere. How should investors be thinking about the spectrum of fixed income opportunities, both public and private, in terms of a diverse portfolio for the next ten years?

**Ashok:** Well, one thing we're big believers in – and, you know, I think this is supported by a lot of portfolio theory – is that if you take different asset classes that have different correlations or different types of return streams against each other, and put them together, you're likely to end up with a more efficient portfolio at the end of the day. And that is a belief we have. It underlies

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a lot of how we invest across markets. And so, you know, I think the natural conclusion that comes out of that is as the private markets continue to grow and continue to offer different types of investments to investors, whether it's consumer lending activity, or a corporate private lending activity to a different type of company that we don't see in the public markets, mixing and matching those with public securities is likely to result in more efficient portfolios over time.

So that's a philosophical belief, and I think the markets are migrating in that direction. And, you know, it's not going to be an overnight trend, but certainly the signs are pointed in that way, at least to us. But I think the second element of it is this low interest rate environment. Um, you know, we've been in basically zero percent interest rates for – since 2008. Investors still need income, they still need bond like returns, and as this goes on and on, investors are quite naturally saying, you know, hey, how can I earn different types of premiums? Can I earn a complexity premium and a liquidity premium? And those are a bit more available in the private market. So the monetary policy environment, is certainly, I think, rationally leading investors to look across this broader spectrum of fixed income investments.

**Anu:** Yeah, terrific, thank you. Now my next question is a little bit about disruption. We're going to stay on brand for the name of this podcast. Most of the markets that, you know, Susan, you're looking at, and maybe Ashok as well, are generally U.S. focused. What about outside of the U.S.? Where are you seeing interesting trends globally, or, again, any disruptions to share that you think are interesting?

**Ashok:** Well, I'll jump in. The trend is definitely more in the US. I mean, of growth of these private markets which is in Europe and Asia. These are markets that have traditionally had more of their debt issuance come through the-the banking systems. And so the-the regulatory changes that came out of the financial crisis I think impacted more, you know, structural changes in the US. There's an active private market in Europe for corporate lending. There's some consumer lending in Europe. But the real growth has been in the US markets.

**Susan:** If I can jump in on disruption, Anu, I do want to point out that even in private debt defined as corporate lending – right? – which is a subsection of private debt. There's still a wide variety of different types of investing that people are doing. And I do sort of sort people on a spectrum by perhaps more risk seeking, return oriented behavior. And less risk seeking, more capital preservation behavior. I often like to joke that since private debt is not a technical term, you can either fixate on the word private, which implies, sexiness and premium, or you can fixate on the word debt, which means, you know, capital preservation. Right? [Laughs]. "We-we lent the money; we'd like it back please. Thank you very much." And so, there are fewer pockets – at this point it's a reasonably mature asset class. It's growth-y, but it's well covered. There are fewer pockets of disruption on corporate lending. So pay attention, I think, to where different managers are in terms of this risk seeking spectrum, versus capital preservation spectrum.

**Anu:** Yeah, no, perfect. Thank you very much for that, Susan. Um, and just as we wrap up here, I'm going to do a quick lightning round with both of you for some final thoughts, um, on these asset classes. So, I'll have Susan, you respond first, and then Ashok can follow. My first question is, what is your favorite aspect of the asset class that you focus on?

**Susan:** I would say, in private asset classes, investors are gifting you with their trust and their capital for three to five years, on average. Um, that's a big sign of trust, which we appreciate. It means that we can invest in a very patient and selective fashion, which, you know, honestly, makes our lives easier, and I think the returns better.

**Anu:** Perfect. And Ashok? [Laughs]

**Ashok:** Susan gave such a good answer I don't have anything to add onto that. Um, you know, we are really lucky that clients entrust us with their capital, and, you know, trying to do a good job for them is the most fun part of this job.

**Anu:** Perfect. Very diplomatic answer, thank you. Um [laughs], and Susan, next question for you. Biggest challenge ahead in your asset class?

**Susan:** So growing risk tolerance, right? I think we've all been through a bit of a rollercoaster. We're not off the ride yet. People feel a lot more optimistic. That is for good reason. But this is entirely the sort of time that people could get a little bit ahead of themselves in terms of being a little too risk seeking, and not focused enough on capital preservation. And so it's important to be aware of that and just be very careful.

**Ashok:** And I think I'll say the biggest challenge is inflation. And there's still uncertainty about whether we're in a shifting, structurally shifting inflation environment. But odds of that are rising, and one hasn't had to invest in that kind of backdrop for 30-plus

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years. That's going to be a-a big change, and I think it's going to lead to-to both surprises in how different asset classes, um, work, and it's going to require different portfolio solutions, because it's fundamentally going to be a different backdrop.

**Anu:** Yeah, sure, absolutely. Thank you. Now, Susan, if investors can take one thing away from today's conversation, what should that one thing be?

**Susan:** I'm going to be naughty and go with two anyway. [Laughs]. The first is private debt really is a core asset class now, it's not as esoteric as people thought it was maybe ten years ago. But correlated to that is it's really not a complicated asset class. You're just lending money to companies that you think will pay you back as well as coupon underwriting fees, prepayment premiums. So anybody who tries to make it out to be more complicated than it is, you know, they're just wrong.

**Anu:** [Laughs]. Perfect. And Ashok, same question to you.

**Ashok:** Yeah, I would take it to a similar point, which is public and private fixed income, you know, lines between these markets, are blurring. And public-private fixed income, which perhaps, um, have this reputation of being these two separate markets. Um, risk factors are similar, um, type of borrowers have similarities, and, you know, over time, um, public and private fixed income are going to sit next to each other for a lot of investors and portfolio solutions, and certainly more than-they do today.

**Susan:** I could not agree more with that.

**Anu:** Great. Thank you very much. My absolute final, final question for you – this is a one-word answer. Susan, you go first. Is a hotdog a sandwich or a taco?

**Susan:** Sandwich. [Laughs]

**Anu:** Ashok, same question.

**Ashok:** A hotdog's a hotdog. I believe it should merit its own – its-its own class, or it's part of the – the overall sausage family in which the bratwurst and other types of wursts sit with the hotdog.

**Anu:** Again, very diplomatic answer, Ashok. Thank you very much. [Laughs]. We'll let you think about that after the episode ends, but that was a-a fun way to end the episode. Uh, appreciate your perspectives on the credit universe. Will be interesting to see how, uh, public and private credit play out as we progress through this new economic cycle. Susan, Ashok, thank you again for joining me.

**Susan:** Thank you for having us.

**Ashok:** Thank you.

**Anu:** And to our listeners, if you've enjoyed this episode of Disruptive Forces, I encourage you to subscribe to the show via Apple Podcast, Google Podcast or Spotify, or you can visit our website, [www.nb.com/disruptiveforces](http://www.nb.com/disruptiveforces), for previous episodes, as well as more information about our firm and offerings.

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